TD Asset Management

forward PERSPECTIVES

Are Corporate Bonds the Safer Asset Class?

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Are Corporate Bonds the Safer Asset Class?

In earlier editions of *forward*Perspectives, we outlined our preference for equities, specifically dividend-paying stocks, over bonds. While we believe that this view will best serve investors in the coming years, we are not advocating the elimination of fixed income investments from a diversified portfolio. Bonds exhibit many characteristics that help lower overall portfolio risk and provide stability. Where we would caution the reader, however, is on an overreliance of government debt in the current market environment.

As we outlined in our last issue, sovereign nations, especially those in the developed world, have a difficult road ahead. For years, consecutive governments have increased their debt as a percentage of GDP. The recent turmoil in world markets, stemming from Europe, will likely compel many governments to take a sober look at their current financial predicament and force them to make the tough choices needed to control spending. The resulting austerity measures that may be required lead us to believe that we will be in an environment of low growth and low returns for an extended period.

Given the issues surrounding government bonds, investors have begun to question the validity of the safe-haven perception of lending to sovereign nations. Are government bonds really the safest investment available? We would argue that many corporations are in better financial shape than the governments of their jurisdiction. We believe that the strength of corporate balance sheets, combined with the incremental yield provided by corporate bonds, make corporate bonds a better investment on a risk/reward basis than government bonds.

TD Asset Management Inc. (TDAM) is committed to providing thought leadership on key issues impacting markets or the investment climate in general. At a time when information is plentiful but wisdom is harder to discern, TD's Wealth Asset Allocation Committee's new thought leadership series entitled *forwardPerspectives*, offers insight into market opportunities and risks.

Times of Crisis - A Different Perspective

A key difference between sovereign governments and corporations is their natural reaction in times of crisis. During an economic slowdown, a government's counter-cyclical response is to increase spending through stimulus programs to encourage economic activity. Corporations, on the other hand, recognize the impact to their revenues and normally decrease expenses to shore up their balance sheets for the difficult times ahead. When the economy begins to rebound, the balance sheets of corporations that survived the downturn tend to be much stronger than before the crisis.

This is precisely what happened during the global credit crisis of 2007-2008. Government debt expanded dramatically as world leaders attempted to stimulate growth, while corporations cut expenses in an effort to stay profitable. The result: ballooning government debt worldwide and fortified corporate balance sheets with the highest cash levels in years.

Corporate Leverage at a Record Low

Financial position of the non-financial corporate sector

Source: Statistics Canada. Quarterly Financial Statistics for Enterprises

Gross Debt as a % of GDP

Country	2006	2011
Canada	70	84
France	64	87
Germany	68	83
Portugal	64	106
United Kingdom	43	81
United States	61	100

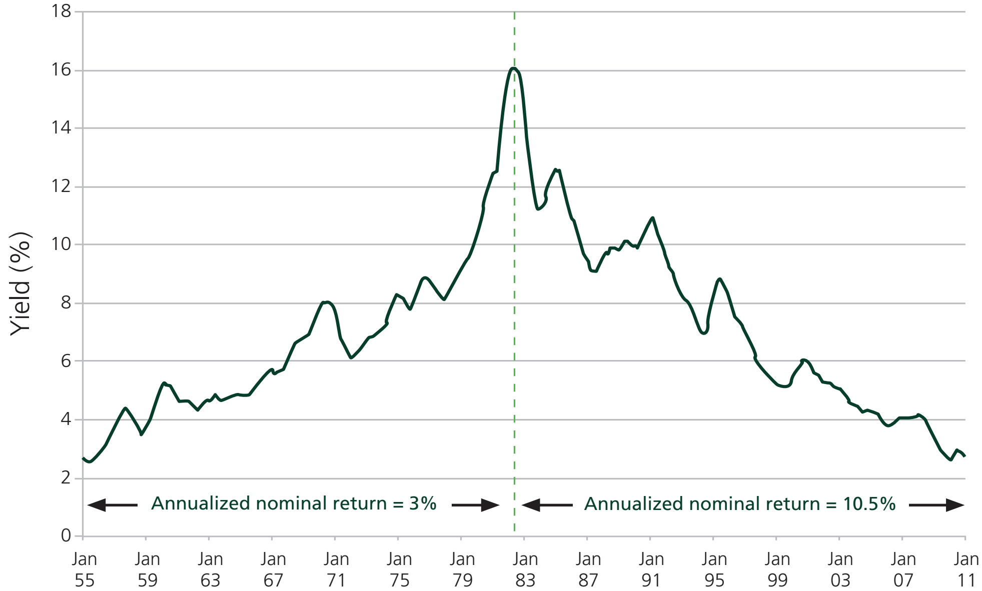
Source: IMF Fiscal Monitor, Sept 2011. Numbers rounded to nearest percent.

One other point to recognize is that each party has different incentives. Chief executive officers are focused on maximizing shareholder value and must have an eye on growing revenues faster than expenses. Politicians are responsible to their electorate to manage the economy and provide services that are of value to the populace. While shareholders are pleased with increased profit margins, most voters do not like cuts in program spending and increases in taxes. In our view, it is unlikely that any politician behaving like a chief executive officer would be re-elected. Accordingly, until voters recognize that high spending and low taxes cannot continue, many governments will have difficulty with their total debt burden.

Investment Grade Bonds

Mounting government debt and the weak global economy have created an ancillary problem for investors – low yields. As central banks eased monetary policy to combat a sluggish economy over the last few years, bond yields declined to historic lows. This has perpetuated a long-term trend. Since the early 1980s, bond yields have been on the decline, providing many bond investors with a 30-year period of capital gains on their holdings in addition to the coupon payments. Logistically, this degree of decline cannot continue. Investors will have to contend with low coupon returns with little prospect for future capital gains.

History of Government of Canada Yields



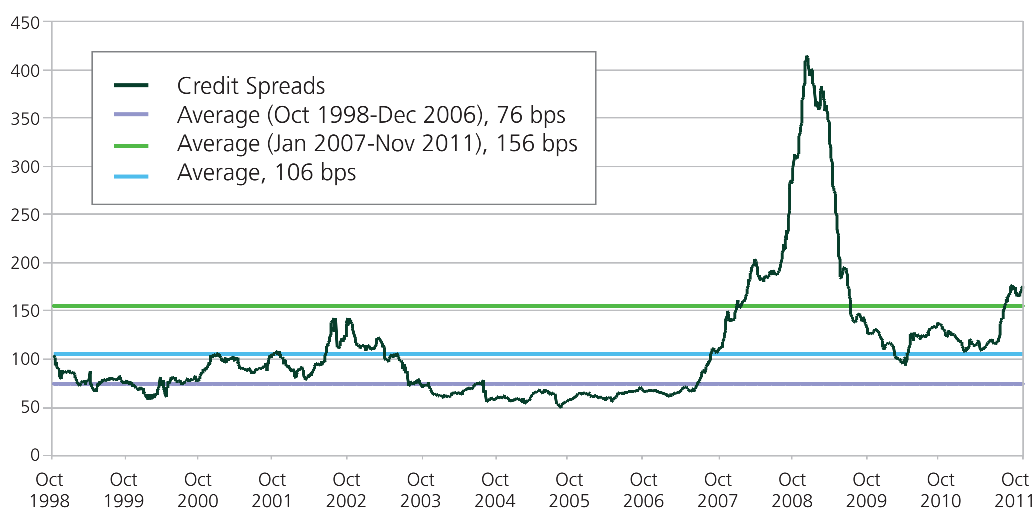
Source: Statistics Canada. Average 5-10 year yields. Data to September 2011.

The high sovereign debt levels, combined with weak economic growth, lead us to believe that we will see lower yields for a longer period. With little chance of capital appreciation, the most bond investors should expect to receive is their coupon payments and principal at maturity. This may not be sufficient for most investors to reach their financial goals.

This is where an allocation to corporate bonds can help. Corporate bonds traditionally provide investors with a spread, or additional return, over comparable government debt. The extra yield is to compensate investors for the additional risk associated with corporate bonds. While selection is critical, we believe that there are many companies with similar risk to government bonds that can provide better returns for investors.

Depending on each investor's risk tolerance, there is the potential to capture greater yield as one moves down the credit curve. Within the investment grade segment, between AAA and BBB rated bonds, there is currently an incremental yield of approximately 170 bps available. This may not appear to be significant in absolute terms, but it is a 100% yield increase over comparable government bonds.[1]

Canadian Corporate Credit Spreads (bps)



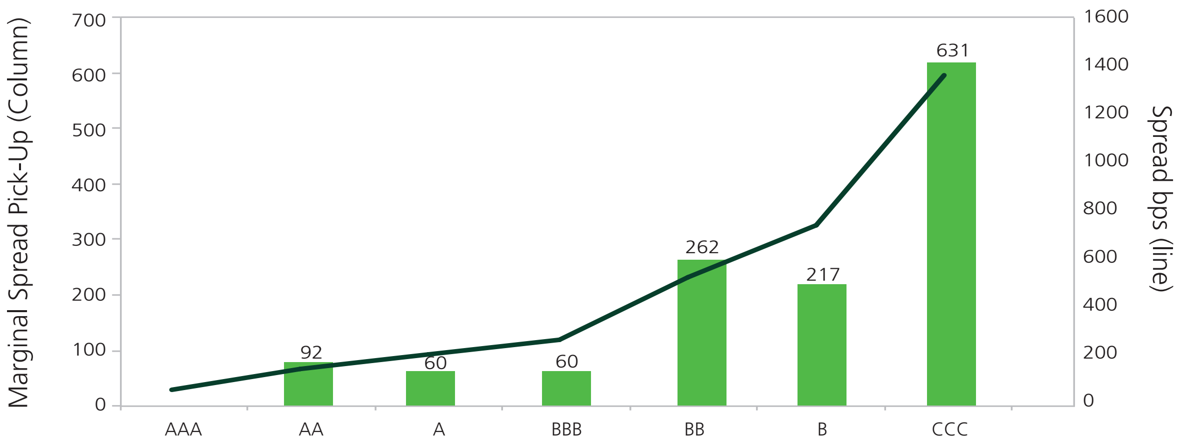
Source: TD Asset Management Inc., as at December 1, 2011.

High Yield Bonds

For investors willing to take greater risk for potentially much higher returns, the non-investment grade, or high yield market, is an option. Traditionally, these high yield companies are stable, mature businesses that generate good cash flow. However, they tend to take on higher levels of debt in order to boost equity returns, thus garnering them a lower credit rating. Accordingly, these companies must offer higher yields to entice investors.

To demonstrate, the chart below highlights the incremental yield pick-up between ratings. As we move down the credit curve, from investment grade to the lowest ratings in high yield, each credit rating compensates investors for taking on greater incremental risk. As investors move from investment grade debt (BBB) to non-investment grade (BB), they are currently compensated with an additional 262 basis points on average.

Credit Curve - November 30, 2011



Default Rate*	0.00	0.062	0.096	0.27	1.07	3.4	13.7
Recovery Rate**	NA	37.2	31.2	41.4	47.1	37.9	35.5

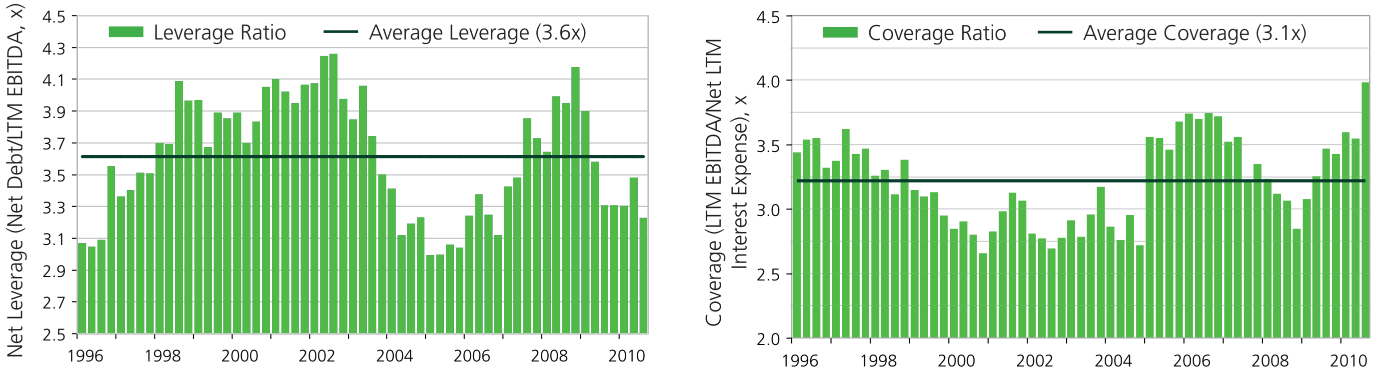
Source: * Moodys 1920-2010, **Moodys 1 yr 1983-2010

Financial Strength

Similar to investment grade companies, many high yield issuers are in better financial shape than they have been in years. Simply put, the weaker companies did not survive the 2008 turmoil. During the credit crisis, as system liquidity dried up, companies with poor credit ratings tended to have greater difficulty accessing bank lines of credit or new funding from bond issuance. As available cash declined, many companies defaulted on their existing bonds and were forced into restructuring or bankruptcy. Firms that were more nimble in controlling costs and able to access funds survived. The net result was that, overall, the surviving non-investment grade companies came through the liquidity crisis with improved financial strength.

Although it is common for the strong to survive difficult economic periods, we find ourselves in an interesting time. Generally, once an economic crisis has passed, many companies revert to their prior expansion plans and begin to accumulate more debt. With a lacklustre economy following the crisis, many executives have been forced to continue to keep a tight control on spending. On average, non-investment grade companies have much higher cash positions available than normal to cover their debt servicing costs, and offer higher yields than their investment grade counterparts.

High Yield Credit Quality Trends



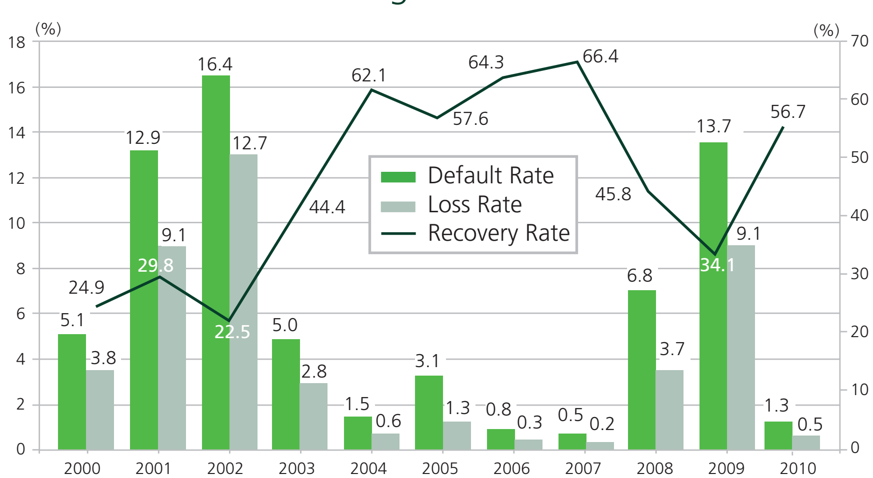
Source: BofA Merrill Lynch Global Research

Default Rates

The primary risk with lending money to non-investment grade firms is the potential for a default on the bond. Although the word default carries worrisome connotations, it usually means that a firm has missed an interest payment. It does not necessarily mean the firm has declared bankruptcy or that there will be a complete loss on the original investment. After a default, the holders of the bond traditionally work with the firm during restructuring to recover as much of their investment as possible. In 2010, the recovery was about 55% of par.[2]

Historically, the high yield market has a default rate of 5.1%.[3] Although the historical average default rate is low, it can increase significantly during times of crisis. It is for this reason that these bonds offer a higher yield to act as a buffer to compensate investors for potential defaults. To minimize the impact of defaults, investors would be well served by owning a diversified portfolio of bonds when investing in the high yield market. That said, considering the current financial strength of corporate issuers, we believe that the near-term default rates will continue to be below the average.

Fitch U.S. High Yield Default Index



Source: Fitch U.S. High Yield Default Index.

We would caution investors on owning bonds with longer maturities as default risk can be higher. As the time to maturity increases, the visibility of future economic events and their impact on the borrowing firm diminishes. Accordingly, we would recommend that investors focus on shorter-dated bonds to reduce this risk.

Our View

Although we continue to favour equities, in these times of economic uncertainty, we believe that fixed income investments play a vital role in an investor's balanced portfolio. We remain concerned about government debt levels but continue to see strengths in the credit market. Corporate bonds, supported by companies' strong balance sheets and cash levels, are particularly attractive relative to government bonds as they provide incremental yield in today's low interest rate environment. However, it is important to remember that appropriate due diligence and credit research is critical to ensure that investors are appropriately compensated for the risks being taken. This is especially true in the high yield market. To take full advantage of the opportunities in the corporate bond market, a professionally managed bond solution may be the answer for investors looking for the best risk/return trade-off.

TD Wealth Asset Allocation Committee

The committee is comprised of ten individuals from different areas of TD Wealth Management businesses with unique investing skills and experiences. The committee was formed in 2009 to:

- articulate broad market themes
- provide macro asset allocation direction
- identify major risks on the horizon

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Ken is vice-chair of fixed income at TDAM. The TDAM fixed income team was awarded the Morningstar® Fixed Income Fund Manager of the Year at the 2010 Canadian Investment Awards.

About TD Asset Management Inc. (TDAM)

TDAM and its affiliates manage over $188 billion in assets, including over $56 billion in equities as at September 30, 2011. Under the TD Mutual Funds name, TDAM provides a diverse range of over 70 mutual funds and 25 professionally managed portfolios. TDAM manages retail mutual fund assets on behalf of more than 1.4 million investors and TD Mutual Funds is one of the most broadly diversified fund families in Canada. TD Mutual Funds are available at TD Canada Trust branches (through TD Investment Services Inc.), TD Waterhouse Discount Brokerage, Financial Planning and Private Investment Advice, as well as leading investment dealers, independent brokers, advisors and financial planners. As at September 30, 2011, TDAM was the fourth largest mutual fund company in Canada, with over $59 billion invested in TD Mutual Funds.

[1] Source: TD Asset Management Inc., as of November 30, 2011. [2] "High Yield Default and Recovery Rate Volatility in Recession and Recovery", Fitch Ratings, March 17, 2011. [3] ibid. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax, trading, or investment advice. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Asset Management Inc., The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. Information is general in nature and is not based on individual suitability. Certain statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, and the general business environment, in each case assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intention of updating any FLS whether as a result of new information, future events or otherwise. TD Asset Management Inc. is a wholly owned subsidiary of The Toronto-Dominion Bank.